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Federal Communications Commission
Office of the Secretary

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To: The Honorable Michael K. Powell
Chairman, FCC

FAX #: 202-418-0232

PHONE #:

FROM: Alfred Kahn

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DATE: March 6, 2003

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Federal Communications Commission
Office of the Secretary
March 6, 2003

VIA FACSIMILE 202-418-0232

The Honorable Michael K. Powell
Chairman
Federal Communications Commission
445 12th Street, SW
Washington, DC 20554

Dear Chairman Powell:

I have nothing but praise for your dissent (**and** that of Commissioner Abernathy) in the recent decision on the obligations of the ILECs under the 1996 Act.

The news accounts **talk** about your resigning. I urge you not to **do so**. As you are fully aware, the fight is **surely** not over: and if there is **any** way in which I **can** be helpful to you I hope you will let me do so (without, I **hope** it **is** unnecessary to assure you, **any** support from Verizon).

I enclose a copy of an op-ed piece about it that I have recently submitted to the *Wall Street Journal*.

With warm regards,

Sincerely,



Alfred E. Kahn
Robert Julius Thorne Professor of Political
Economy, Emeritus, Cornell University;
Special Consultant, National Economic
Research Associates (NERA)

AEK mhu
Enclosure

c Senator John McCain, Chairman
U S Senate Committee on Commerce, Science and Transportation.

3/4/03

Regulatory Politics as Usual

Alfred E. Kahn

The FCC

The Federal Communications Commission's long-delayed—until the last possible moment—3-2 decision of February 20th, purporting to resolve the critical outstanding issues about the obligations of the incumbent local telephone companies (ILECs)—primarily, the Bells—to facilitate the entry of competitors: **is in** one critical respect an abomination, purely political in the worst sense of the term and grounded in neither good economics nor honorable regulatory practice.

I have represented Verizon in some of the relevant FCC proceedings; but insofar as my criticisms of the Commission here coincided with those of the Bells, they are grounded in a book I published more than **30** years ago and reflected in my own practice as a state regulator. Also I have some doubts about one way in which the new decision favors the Bells, freeing them of the obligation to share with competitors the high-frequency capabilities of their copper wires, with Chairman Michael Powell and Commissioner Abernathy dissenting.

The definition and pricing of unbundled network elements (UNEs)

The blatantly political **and** unprincipled **part** of the Decision was *to* return to the states responsibility for defining the unbundled network elements (UNEs) of the incumbent companies' systems **that** they are required to lease to would-be competitors.

The governing Telecommunications Act of 1996 reads as though it contemplates a decentralized process for making these determinations, beginning with applications by would-be competitors to the incumbent for use of specified network elements and negotiations between them, with residual disagreements to be resolved by the state regulatory commissions, subject to ultimate approval by the FCC, with tight deadlines for each step along the way. An activist FCC—eager *to* produce quick results in the form of visible competitors and visible rate reductions—decided instead **six** years ago to go **ahead** and prescribe extremely detailed rules about the results it would find acceptable. My objection was less to **its** assertion of that leading role—upheld by the Supreme Court in

1999—than on the substantive grounds, anticipated by my *Economics of Regulation* some 27 years previously, that the pricing standard it stipulated—the lowest costs achievable by a hypothetical, ideally efficient new entrant—was economically incorrect and dishonorably opportunistic. The basis for the latter accusation was that it deprived these companies of their previous opportunity to recover their historically incurred costs, and dramatically reduced the rate caps that the majority of state commissions had imposed on them only a few years before: some of the prices prescribed called for immediate reductions that would have taken over 20 years to be reached under those.

The major economic objection to the Commission's new pricing prescription was that no competitor could be expected to construct its own facilities—concededly on all sides the most important and effective competition hoped for—if it could free-ride on the facilities of the incumbents at, by design, the lowest possible costs achievable by an ideally efficient entrant. It would be difficult to imagine an arrangement more hostile to the risky and costly investments in modern telecommunications infrastructure and the development of the new products and services that it makes possible.

How, then, can we explain the tens of billions of dollars that competitors actually did invest annually in constructing their own fiber-ring communication networks in the center of every substantial metropolitan area in the country? The answer is that these facilities were in their origin the only means by which long-distance carriers could escape the extortionate fees regulators were forcing the ILECs to charge them for access to their customers to initiate and receive calls, using the proceeds to subsidize residential rates. These competitive access facilities became the basis for CLECs providing the entire range of telephone services, most prominently including broadband, typically to large business users in those areas, whose retail rates were likewise systematically set by regulators far above cost, in order to subsidize the price for basic residential service.

The fact that this form of entry was essentially mere cream-skimming of regulatorily-distorted rates raises the question of whether this was the kind of competition that the 1996 Act contemplated. According to the FCC, CLECs that use ILEC inputs predominantly do not deploy any network facilities of their own, not even switches: as of June 30, 2001, almost three-quarters of the 12.3 million UNE and resold lines they used were, effectively, mere resales or rebranding of the services actually supplied by the

incumbents. Competitive local telephone companies serve approximately 30 percent of all business lines today but only about 9 percent of residential lines. And of that 9 percent almost two-thirds was *exclusively with the use of ILEC facilities*.

This ridiculous policy reached its nadir around 1999 as the FCC confirmed the obligations of the ILECs to include among their "unbundled" elements subject to mandatory provision to competitors at those hypothetical minimum costs the so-called "platform," or UNE-P—the *entire combination of network elements* (switches and transport facilities) necessary to produce the services, with the "competitor" then having the right to market them to retail customers.

It is only fair to disclose that my first objection to the UNE-P was aesthetic: "*unbundled network elements combined into a single bundle*" is an oxymoron.

More substantively: the consequence of the rapid increase in the use of UNE-Ps, beginning three years after passage of the 1996 Act, was actually to produce a *reduction* between 2001 and 2002 in the number of lines served by competitive local telephone carriers (leaving not the rapidly growing cable telephony) with their own facilities. Small wonder. When every applicant can be a free rider, at prices explicitly intended to recover only the minimum cost of construction, who is going to build the vehicle?

That brings us to the first abomination of the FCC's recent decision. Six years after having taken the initiative: its majority decided to transfer full and unreviewable authority, including the power to continue the permissibility of UNE-Ps for residential services alone, back to the State commissions, which are under even more direct and immediate political pressures to produce "results" — paper competitors and visible reductions in residential rates. Chairman Powell and Commissioner Abernathy, dissenting, would instead have simply abolished the UNE-P, on the ground that it produces the semblance of competition but not its substance.

We have already had a foretaste of the dramatic results the politically-minded new FCC majority clearly hopes to achieve, by way of local Bell Companies losing millions of subscribers to such local competitors as AT&T and WorldCom within a space of months. Last year the Michigan Commission cut the state's wholesale rates from about \$17.50 to \$14.44 per line per month. "I really don't care what form the competition

rakes, so long as companies are in their duking it out and fighting for customers," the Chairman **was** quoted as saying. *Some* competitors! **Some** "duking"!

Similarly, the California Commission last May ordered **a 39** percent reduction in combined charges for loops and switching at high levels of usage from \$23 to \$14 a line. And last year, under pressure from the New York Public Service Commission, Verizon entered into a settlement that **had** the effect of reducing UNE rates from \$27.17 per line to \$19.14.

A year or two ago, I published an article, "Bribing Customers to Leave and Calling it 'Competition.'" I was referring there to the policy deliberately adopted by some states of forcing local electric utility companies to give rebates to retail customers who desert them for competitive distributors—that is, the portions of the distribution charges that customers would escape if they deserted their historical retail supplier and shifted their patronage to a competitor—larger **than** the costs **that** their departure would actually save their historical suppliers. In effect, their commissions would reason: "we estimate that customers who desert their local utility suppliers will **save** it, say, **3.5** cents a kwh—the cost of the energy it will no longer have to purchase in the wholesale market in order to supply them—but we will **malic** the company give them a 'shopping credit' of **1.5** cents, in order to encourage them to **shift**." The Pennsylvania Commission, to cite the outstanding example to date, deliberately prescribed a "shopping credit" large enough to produce something like a 10 percent rate reduction for customers who shifted to competitive marketers; and one of its commissioners then boasted that as a result more customers had shifted in that state than in the entire remainder of the country. Small wonder.

Now the same thing has been happening in the telephone industry and a politically motivated FCC, overriding its own chairman, **has** invited the states to continue to **do** so—with the apparent approval of *The New York Times*, on the ground that "consumers are only **now** beginning to benefit" from "competition." **Some competition!**